DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0187
Gross Income Tax and Adjusted Gross Income Tax
For the Years 1999-2002

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ISSUES

I. Business / Non-business Classification – Adjusted Gross Income Tax.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2; I.R.C. § 332; I.R.C. § 334; I.R.C. § 336; I.R.C. § 337; I.R.C. § 338; *May Dep't Stores Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001); *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001); *Jim Beam Brands Corp. v. Franchise Tax Board*, 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 1st Dist. 2005); *Times Mirror Co. v. Franchise Tax Board*, 162 Cal. Rptr. 630 (Cal. Ct. App 2nd Dist. 1980).

Taxpayer protests the imposition of adjusted gross income tax with respect to the deemed liquidation of an affiliated company by Taxpayer's parent.

II. Interstate Transportation – Gross Income Tax

Authority: IC § 6-2.1-2-2 (repealed effective January 1, 2003); IC § 6-2.1-3-4; IC 6-8.1-5-1.

Taxpayer protests the imposition of gross income tax with respect to receipts that Taxpayer claims were the result of interstate transportation.

III. Tax Administration-Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a corporation that filed a consolidated return on behalf of several affiliates. Taxpayer had a wholly owned sister company ("Subsidiary") which in turn owned another company ("Company"). Taxpayer's consolidated return included Taxpayer and Company; however, the return did not include Subsidiary because Subsidiary lacked nexus with Indiana. The consolidated return did not include Taxpayer's parent company ("Parent") after 1998

because Parent also lacked Indiana nexus. In 2000, Company was sold to an unrelated third party. Parent (the taxpayer for federal purposes) and the third party made an election under I.R.C. § 338(h)(10) to treat the sale as a deemed asset sale of Company's assets. Taxpayer reported the gains from Company's sale as nonbusiness income. The Indiana Department of Revenue ("Department") reclassified the income as business income and assessed additional tax, penalty, and interest.

In addition, Taxpayer had another division ("Division") which operated rail service between Indiana and Illinois. During the audit, Taxpayer did not provide documentation to verify the revenues claimed by Division as interstate transportation revenues. The Department determined that all income derived by Division from Indiana sources should be attributed to Indiana because Taxpayer did not distinguish intrastate revenue from interstate revenue. Therefore, the Department assessed additional tax, penalty, and interest.

Taxpayer protested both issues with respect to the assessments. The Department conducted an administrative hearing, and this Letter of Findings results. Any issues not specifically discussed in this Letter of Findings are considered to be resolved based on Taxpayer's originally filed return and any Department modifications to that return.

I. Business / Non-business Classification – Adjusted Gross Income Tax

DISCUSSION

In general, the sale of stock in a corporation ('target corporation"), such as Company's sale in this protest, results in income to the shareholders that sold the stock. The target corporation retains its basis in the underlying assets.

Generally, if a corporation liquidates its assets, it is treated as selling its assets to its shareholders at the fair market value of the assets, and the corporation realizes income or loss accordingly. I.R.C. § 336. The shareholders receive a basis in the assets received equal to the fair market value of the asset at the time of liquidation. I.R.C. § 334. For purposes of discussion, this treatment is called "shareholder treatment."

However, if a liquidation of a corporation's assets to its parent occurs, the liquidating corporation does not realize any gain or loss on the sale of its assets, but the parent retains the basis in the assets that the liquidating corporation had in those assets. I.R.C. §§ 332, 337.

Under I.R.C. § 338(a), a purchasing corporation of a target corporation may elect shareholder treatment with respect to its assets. The assets in the deemed liquidation are treated as having the same fair market value of the stock purchased (subject to certain exceptions not material to this case) and are treated as being distributed back to the target corporation the day after the acquisition. Thus, the target corporation is treated as realizing gain or loss on its assets, and it receives a stepped-up (or stepped-down) basis in its assets.

Under I.R.C. § 338(h)(10), shareholder treatment is permissible for the seller's consolidated group. Thus, the gain or loss from the deemed liquidation under § 338(a) is recognized by the consolidated group. However, unlike regular shareholders who are treated as selling their stock for the value of the assets received in liquidation under I.R.C. § 331, the seller's consolidated group does not realize gain or loss from the sale of stock.

In the transaction from which this protest arose, Parent made a 338(h)(10) election with respect to the sale of Company, and thus Company was treated as liquidating its assets on the date of the sale, and Company was treated as realizing income on this sale for federal income tax purposes, while Parent included this income on its consolidated federal income tax return.

The question for Indiana is whether the income from the deemed liquidation of Company's assets is business income or non-business income. Although Parent was the *federal* reporting entity for federal purposes and thus the entity on whose federal return the gains from the sale of Company's assets was reported, Company is the entity that is deemed to have sold its assets. Taxpayer is the *Indiana* reporting entity, and thus any income or deductions that Company received were reported on Taxpayer's Indiana return.

IC § 6-3-1-20 provides:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business.

Conversely, IC § 6-3-1-21 provides that "nonbusiness income" means all income other than business income.

Under the provisions of IC § 6-3-2-2, business income of a corporation is subject to apportionment to Indiana, while nonbusiness income is generally allocable to the corporation's domicile.

In *May Dep't Stores Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001), the court determined that the definition of business income encompassed two tests. The first test, the transactional test considers

> (1) the frequency and regularity of similar transactions;
> (2) the former practices of the business; and
> (3) the taxpayer's subsequent use of the income.

Id. at 658-659.

In *May*, May Department Stores ("May") purchased a rival department store chain. As a result of the purchase, an antitrust case was launched against May. In settlement of the antitrust claim, May sold the assets of one of its divisions, Home. As a result of Home's asset sale, May realized a gain that it treated as nonbusiness income, allocable to May's domicile; however, the Indiana Department of State Revenue determined that the income was business income apportionable to Indiana and other states. The court held that, because the sale of the assets was a one-time transaction, the sale failed to meet the transactional test for business income. *Id.* at 664

Applying the test from *May*, the sales of Parent's interests in Company did not meet the transactional test due to the one-time nature of Company's liquidation and asset sale.

The second test, the functional test, "dictates that acquisition, management, use or rental, *and* disposition of property must constitute integral parts of regular business operations." *Id.* at 660

(emphasis added). In *May*, the court noted that the sale of the assets of the division in question was done to benefit a competitor, rather than May. As a result, the sale could not have been an integral part of May's business, and therefore the sale failed to meet the functional agreement. *Id.* at 665.

First, Parent operated this business for several years as part of its overall business. For those years, Parent (and for 2000, Taxpayer) had claimed expenses and depreciation related to Company as business expenses to Indiana and other states, reducing the income apportionable to Indiana.

Though Indiana has issued one business/nonbusiness income Tax Court decision, which was based on a forced sale of a company, California has decided several cases regarding the business/nonbusiness income distinction. While California law is not binding authority in Indiana, California's legal constructions are noteworthy because its statutes and rulings formed the basis of the Uniform Division of Income for Tax Purposes Act (UDITPA), *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324, 334-335 (Cal. 2001), and Indiana has generally based its corporate tax statutes on UDITPA. *May*, 749 N.E.2d at 651.

In *Hoechst Celanese,* a company had established a retirement pension plan for its employees. The company had no rights to the surplus assets until the termination of the pension plan and satisfaction of benefits. *Id.* at 328-329. In 1983, the company had decided to recapture the surplus in order to prevent its use in a potential takeover bid. The company divided the original pension plan and trust into two separate pension plans and trusts, one for active employees and one for retirees. *Id.* at 329. Thereafter, the company purchased annuities to cover the pensions for retired employees and terminated the trusts. The series of transactions triggered the reversion of a sizable surplus to the company, which the company maintained in its general fund. *Id.* at 329-330. In deciding that the income in question was business income, the court noted that the pension plan was part of the company's overall strategy of finding and retaining employees for its business operations. Further, with respect to the income at issue, the court noted that the taxpayer had received a deduction against its business income for its pension contributions. Accordingly, the court noted that the recapture of income resulting from that deduction was equitable in light of the circumstances. *Id.* at 343.

As was the case with the company in *Hoechst Celanese*—which used the pension plan expenses to reduce its business income apportionable to California prior to the liquidation of the retirement plan—Parent and Taxpayer were able to use Company's expenses, depreciation, and other deductions to offset its income apportionable to Indiana. Just as the court in *Hoechst Celanese* noted that the recapture of income upon which the company had previously claimed a deduction was equitable in light of the previous deductions, the recapture of Company's business deductions as business income is equitable in the current protest.

Furthermore, California has considered the issue with respect to the sale of subsidiaries in the normal course of a taxpayer's business. In *Jim Beam Brands Corp. v. Franchise Tax Board*, 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 1st Dist. 2005), Jim Beam owned all the shares of a subsidiary, Clear Spring, which in turn owned all the shares of yet another company, Taylor Foods. In 1987, Clear Spring sold its shares in Taylor Foods. The reason given for the sale was that Taylor Foods did not fit into Jim Beam's long-term plans. The proceeds were distributed from Clear Spring to Jim Beam and thenfurther to Jim Beam's parent. Jim Beam had classified the income as nonbusiness income allocable to Jim Beam's Kentucky domicile. Previously, Jim Beam had

treated Taylor Foods as part of its unitary group and had treated its income and deductions as business income or business deductions. However, California sought to treat the income as apportionable to California.

The court considered whether the property itself was used for the production of income as an integral part of Jim Beam's operation, rather than whether the mere disposition of that property was an integral part of Jim Beam's operation. The court held that Taylor Foods was used to produce business income, and as a result the income from the disposition of Taylor Foods constituted business income. *See also Hoechst Celanese* 22 P.3d at 343 (distribution of excess pension funds to preclude use by other corporations possible takeovers resulted in business income when the corporation had claimed its payments into the fund as business deductions); *Times Mirror Co. v. Franchise Tax Board*, 162 Cal. Rptr. 630 (Cal. Ct. App 2nd Dist. 1980) (disposition of a wholly-owned subsidiary held to be business income).

Here—just as Taylor Foods was part of petitoner's business in *Jim Beam*—Company was part of Parent's overall operation. Similarly, even though Jim Beam did not even retain the funds from the sale of Taylor Foods or continue to operate Taylor Foods, Taxpayer did not continue to operate Company. Nevertheless, Company was a part of Parent's overall business. The fact that it was sold as a part of Parent's overall business plan did not change the character of the property in question. Company's assets were business property and remained business property even in when it was ultimately disposed.

The Department is aware of the cases cited by Taxpayer in support of its protest. However, the Department considers the approach taken by California with respect to the business/nonbusiness income distinction to be persuasive based on the underlying policy of UDITPA and the history of UDITPA being based largely on California law.

Taxpayer raised a second issue regarding its apportionment factors due to the determination of Company's income as business income. Taxpayer argues that its sales numerator should include any sales proceeds to Indiana assets, while the denominator should include the total sale proceeds. Taxpayer is correct with respect to this argument; however, the audit made the appropriate adjustments to Taxpayer's sales numerator and denominator.

FINDING

Taxpayer's protest is denied.

II. Interstate Transportation – Gross Income Tax.

Taxpayer protests the imposition of gross income tax with respect to interstate transportation receipts. During the Department's audit, Taxpayer did not allow the Department to review Division's records of its Indiana transportation receipts. As a result, the Department determined that all Division's receipts attributable to Indiana were Indiana-only transportation receipts.

IC § 6-2.1-2-2(a)(2) (repealed effective January 1, 2003) provided a general rule that gross income tax was "imposed upon the receipt of[] the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." IC § 6-2.1-3-4 provided that

> Gross receipts derived from transportation charges or other charges directly related to transporting:
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> (1) property by truck or rail; or
> (2) passenger by bus or rail;
>
> are exempt from gross income tax if the transportation is an initial, intermediary, or final link in the interstate transportation of the property or the passengers.

The issue is whether Taxpayer has met its burden of proof regarding Division's receipts, as required under IC § 6-8.1-5-1. Taxpayer provided documentation that showed the breakdown of Division's receipts by intrastate and interstate transportation sources. With the documentation, Taxpayer has provided sufficient information to conclude that the Department assessed tax on both intrastate (taxable) and interstate (exempt) receipts. However, Taxpayer's information regarding Division's intrastate receipts still shows that Division underreported it intrastate transportation sales. Thus, Taxpayer is sustained to the extent that its documentation demonstrates that Division's income was derived from interstate transportation, and denied to the extent that the documentation demonstrates that Division's income was derived from transportation solely within Indiana.

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Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration-Penalty

DISCUSSION

Taxpayer also protests the imposition of the penalty for negligence for the years in question. Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code, 45 IAC 15-11-2, further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
>
> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving

> rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
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> (3) judicial precedents established in jurisdictions outside Indiana;
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> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
>
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

With respect to the penalty imposed on its 2000 deficiency, Taxpayer has presented sufficient legal and factual information that it acted with reasonable care expected of taxpayers, and thus the penalty should be waived for that year. However, with respect to 1999, 2001, and 2002, Taxpayer has not made a showing of reasonable cause, and thus waiver is denied.

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Taxpayer's protest is sustained with respect to 2000, and denied with respect to 1999, 2001, and 2002.

JR/BK/DK February 20, 2007